

THEME: ACCOUNTS PAYABLE

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ACCOUNTING TERM: Accounts Payable

An account payable is normally an unsecured, non-interest bearing current liability, owed by the company to a vendor for the purchase of trade goods or services.

FEATURE ARTICLE: Accounts Payable Accounting

If you are a small business owner or manager and you are having trouble keeping track of all those outstanding bills that have to be paid each month, perhaps you need to set up an accounts payable system.

Some small businesses may not need to have a full-blown accounts payable system to manage the payments of their monthly debts. This is usually because the nature of the business has minimal vendor purchases, cash flow is adequate enough to pay all bills within 30 days, and the routine bills to pay each month are predictably the same.

Other small businesses do require an accounts payable system because their situation is exactly the opposite. They have many vendors and need extended credit to make sure inventory is purchased in a timely manner. They also need the flexibility to pay bills as cash becomes available.

To understand how an accounts payable system works, you must have a grasp of the “accounts payable formula”. It is set up like this:

Beginning accounts payable (last month’s ending balance)	XXXXXX
 Add purchases on account	XXXXXX
 Subtract cash payments on account	XXXXXX
 Add or Subtract adjustments	XXXXXX
Ending accounts payable balance	XXXXXX

There are two ledger accounts to keep track of: 1) The “detail accounts”; and 2) the “control account”. The detail accounts relate to each individual vendor’s account and the control account relates to the summary of all the detail accounts. Fortunately, we have computers that take the drudgery out of posting all the detail information to the various ledgers.

Here's an overview of how an accounts payable system works: Let's say you are a small mom & pop retail corner grocery store. You have a contract with fifteen or so vendors to keep your store stocked with goods to sell. You anticipate how much of each item you are going need and place your orders accordingly. You use a purchase order (PO) system to keep track of your orders. When the orders are delivered you check to see if they are correct. If so, you can enter the invoice into a "purchase journal". The purchase journal records what you bought, who you bought it from, the date purchased, the amount, and the general ledger account to which the item is posted.

Since you are using a computer, all the information is automatically disbursed from the Purchase Journal into two other ledgers: 1) the individual vendor's ledger (detail accounts); and, 2) the general ledger (Accounts Payable control account). You can generate a report from these ledgers that will show every entry made. For instance, the Vendor Ledger report will show, by vendor, every item you purchased, any adjustments, and any payments made to his/her account. The Detail of the General Ledger report for the Accounts Payable control account will show every entry made to each vendor's account by the date occurred. It also shows which ledger or journal the entry came from so an audit trail can be followed.

An Accounts Payable Aging Report can be run that shows the outstanding balances owed to each vendor by how old the debt is. These outstanding amounts are arrayed by thirty, sixty, ninety, one hundred twenty days, and over.

Accounts payable accounting procedures are straightforward, if you remember how debits and credits work. If you have forgotten, click on this link to my accounting model diagram for a review.

http://www.reallifeaccounting.com/accounting_model.asp

When you purchase goods or services you may be increasing an asset account (Inventory) or an expense account (Rent or Utilities, etc.). An increase to an asset or an expense account requires a debit entry. At the same time, you are incurring a liability because you are not paying cash for the purchase. Therefore, you are increasing a liability account called Accounts Payable. You may recall that an increase to a liability account requires a credit entry.

DESCRIPTION	DEBIT	CREDIT
Inventory	1,000	
Utilities	500	
Accounts Payable		1,500

At this point, you have one side of your entry made. The other side is made when you pay your vendors. This is done through the cash disbursements system or check writing system. You may use computer checks or manual

checks, but either way the payments are entered into the cash disbursements system. The computer will automatically know (if you set it up beforehand) that the vendor you are paying is part of the accounts payable system. When the check is posted, the vendor's individual account and the accounts payable control account both will be simultaneously decreased. Let's review the debit and credit procedure:

- 1) Purchase: Debit Inventory or Expense (increase) credit Accounts Payable (increase)
- 2) Payment: Debit Accounts Payable (decrease) and credit Cash (decrease)

That's not too complicated. If confusion comes, it usually happens when making an adjustment to a vendor's account. Adjustments happen for a variety of reasons, such as for returned goods, a mistake, a discount, etc. You simply have to think out clearly the increase or the decrease to the account.

The bottom line in the accounts payable process is to "**prove your work regularly**". Keep in mind the accounts payable formula mentioned above. Each ledger and report follows that formula. The individual vendor detail report total *must* tie (be the same as) the General Ledger (GL) Accounts Payable control account total. The latter is only a summary of the former so the totals should be identical. If not, you must research why. It may require going back to the original vendor invoice, which is your source document, and comparing each one to the amounts entered into the computer to find the discrepancy. Catch mistakes early and you can quickly resolve them. If you wait to prove your work, mistakes will compound on each other and it can become a "rat's nest" to unravel.

QUESTION: What If I Can't Pay My Accounts Payable On Time?

If you find yourself in the unpleasant situation where you simply cannot pay all your vendors on time, then you need a strategy. There are all kinds of reasons why a company may be in a cash-short position. It could be temporary (hopeful) or permanent (dreadful). In either case, you have to try to manage the circumstances so that they don't manage you. Ignoring the problem is a strategy, but not a good one because it motivates the vendors to become extremely aggressive. The vendor wants assurance he/she is going to get paid. Your job in this crisis is to give that assurance to the vendors. Here are some suggestions as to how to do that:

- 1) Always return phone calls in a timely manner. In other words, communicate!
- 2) Explain the situation so the vendor doesn't think you are a flake or that you are going out of business.

- 3) Think out what payments have to be made to keep the doors open. Determine how much money you have remaining to pay outstanding balances to creditors. Make an agreement to pay *something* to each vendor every month. Do not renege without communicating.
- 4) Do not tell the vendor you are waiting for a new investor to supply fresh money. They will know the company is not viable.
- 5) Sign a term note with low payments that you can afford. This is an affirmation to the vendor that you are serious about satisfying the debt.
- 6) Use the Accounts Payable Aging report to keep track of vendor liabilities. Take good notes regarding promises and agreements so you don't forget.

Communicating will go a long way to forestall any legal judgments against the company forcing you to use your limited resources for non-essential purposes. For instance, the rent or electricity bill is probably more important to pay than an inventory line that produces secondary sales revenue. Vendors want your continued business even though they may require cash-on-delivery (C.O.D) for any new inventory. Many vendors can become amazingly supportive and understanding as long as you keep talking to them.

TIP: How Accounts Payable Works When Using Modified Cash Basis Financial Statements

First, let's clear up what a Modified Cash Basis Financial Statement is. You may recall from a previous article, *Accrual vs. Cash*, that for a financial statement to be in accordance with Generally Accepted Accounting Principles (GAAP) it must be prepared using a full accrual method. However, a "hybrid" method is allowed whereby a company may use a combination accrual and cash method. A Modified Cash Basis is a hybrid method. It is still not a GAAP statement, but it is an acceptable way of presenting financial statements if the methods used are properly disclosed.

A company using the Modified Cash Basis may exclude accounts payable and accounts receivable altogether, or it may use one and not the other. Alternatively, it may use an accounts payable method that does not include every single outstanding bill. This is the situation I would like to discuss. Companies that use the Modified Cash Basis do so because they are cash basis taxpayers and it is easier to convert a Modified Cash Basis financial statement to the tax return.

For instance, let's say a company, which is on an accrual method for financial reporting is a cash basis taxpayer. The financial statements have to be modified at the end of the year to conform to the cash basis tax return. What a pain! All

the outstanding accounts payable charges have to be reversed. A company that has accounts payable, but only for vendors who sell inventory, can avoid this hassle because the only adjustment will be to one account, Inventory. For example:

Beginning Inventory balance is \$10,000.

Accounts Payable balance is \$2,000.

To conform to cash basis the accounts payable balance must be reduced to zero.

DESCRIPTION	DEBIT	CREDIT
Accounts Payable	2,000	
Inventory		2,000

The cash basis inventory is reduced to \$8,000 and accounts payable is zero. The company has been able to keep track of its vendor liabilities and, without much trouble at all, conformed to its cash basis taxpayer status.

Keep in mind, that if there is still a remaining inventory balance (\$8,000) after the accounts payable inventory purchases have been removed from inventory, you can assume the entire inventory balance was purchased with cash. This means you will have removed the inventory purchased via accounts payable before it was sold. That being the case, there will be no non-cash inventory items to be taken out of cost-of-goods sold.

However, if inventory were only \$1000 the adjustment would look like this:

DESCRIPTION	DEBIT	CREDIT
Accounts Payable	2,000	
Inventory		1,000
Cost of Goods Sold		1,000

The cash basis profit would increase by \$1,000 because the expense account, cost-of-goods sold, had to be decreased by non-cash expenditures (accounts payable charges).

On the other side of the coin, if the company also had an accounts receivable balance of \$5,000 then a journal entry to adjust to cash basis would look like this:

DESCRIPTION	DEBIT	CREDIT
Sales	5,000	
Accounts Receivable		5,000

This would decrease the company profit by \$5,000 because non-cash sales are being removed.

You can see that the reason some businesses choose the Modified Cash Basis over full Accrual is practical in that time is saved using a more simple approach when preparing financial statements.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.